Fiscal frameworks and fiscal sustainability in the Nordics

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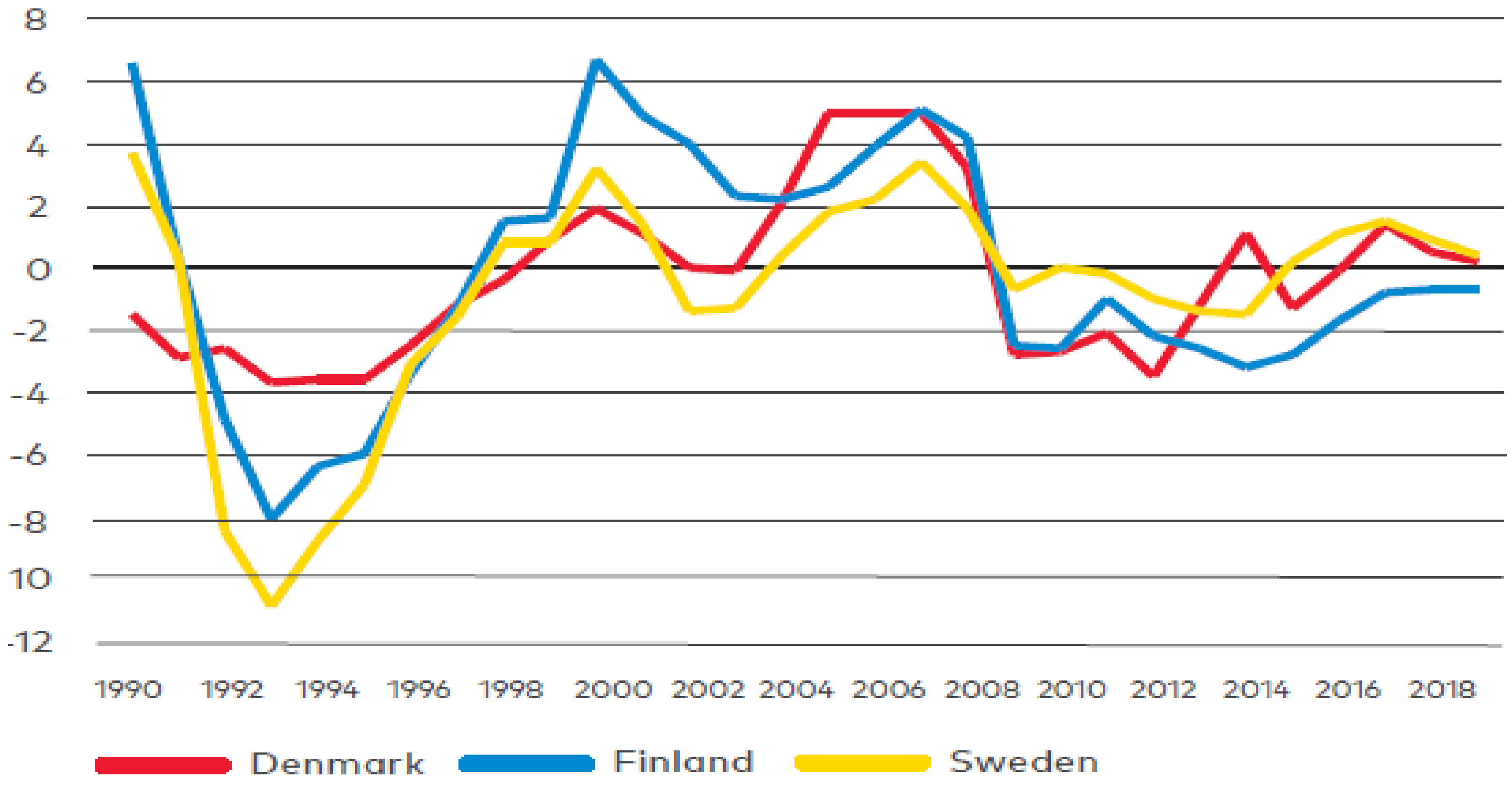
Nordregio, Swedish Fiscal Policy Council and Nordic Council of Ministers

My presentation

- ”Current” fiscal situation
- Fiscal rules
- Fiscal-policy monitoring
- Fiscal sustainability analyses

Fiscal balance, percent of GDP



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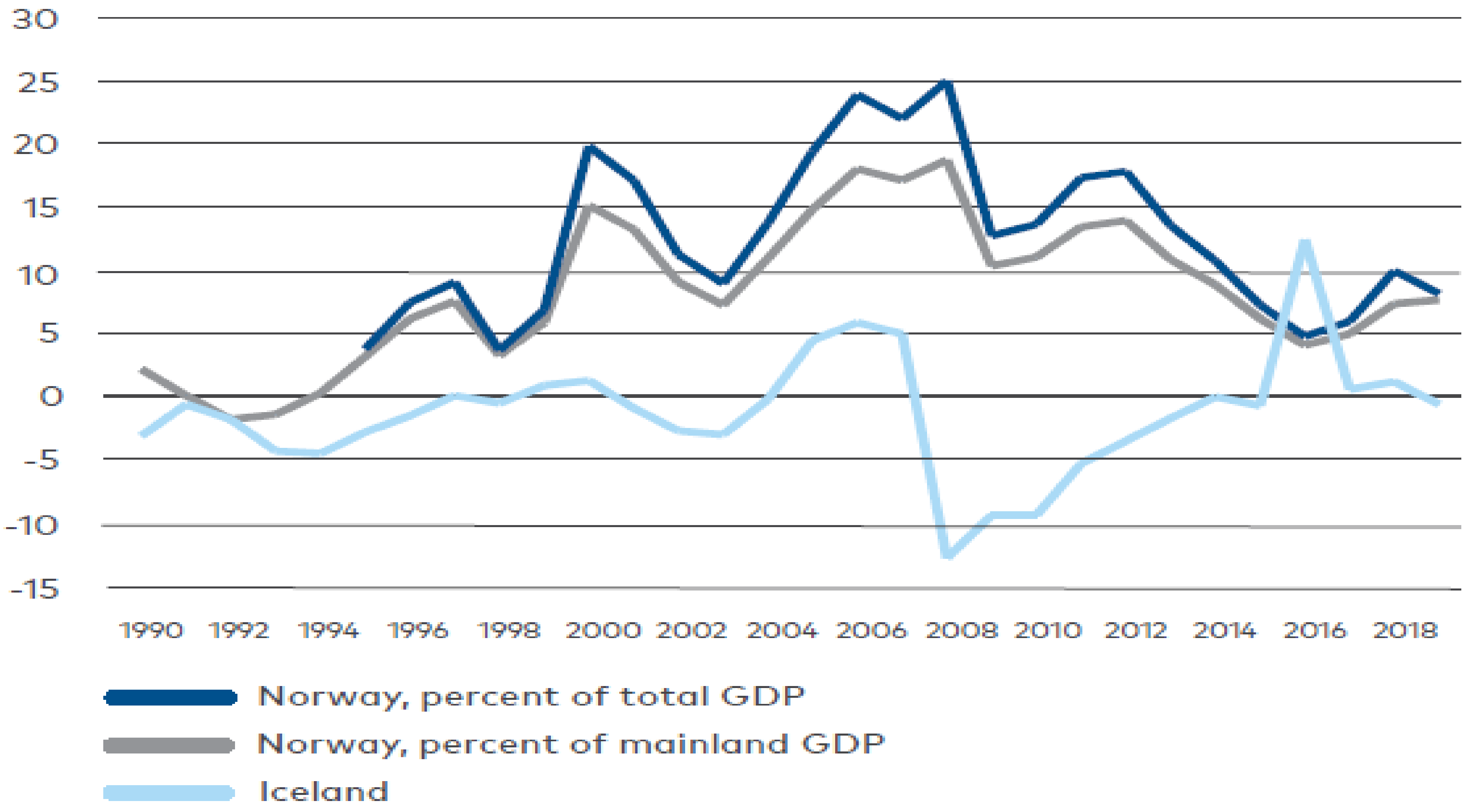
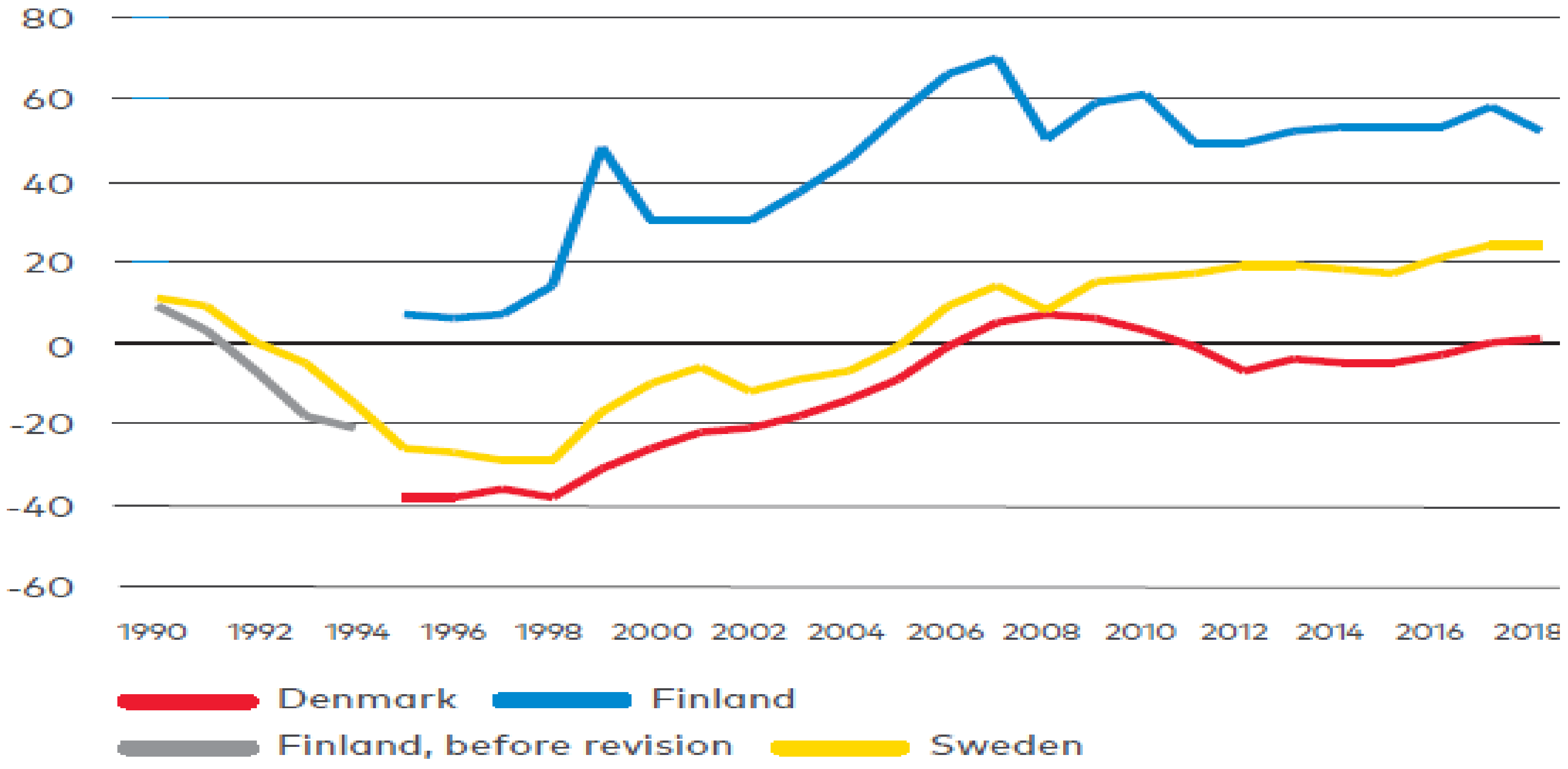


General government net financial wealth, percent of GDP



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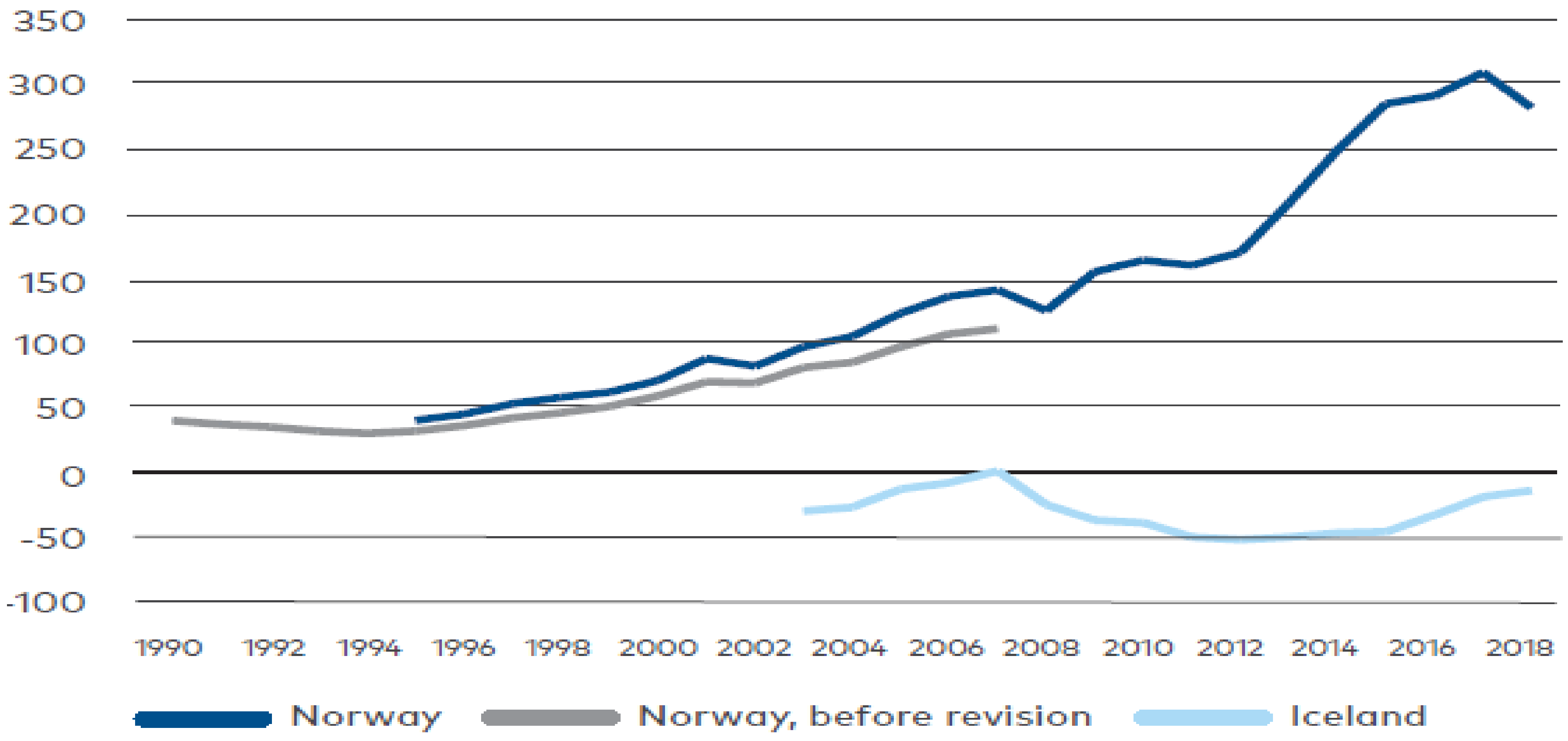
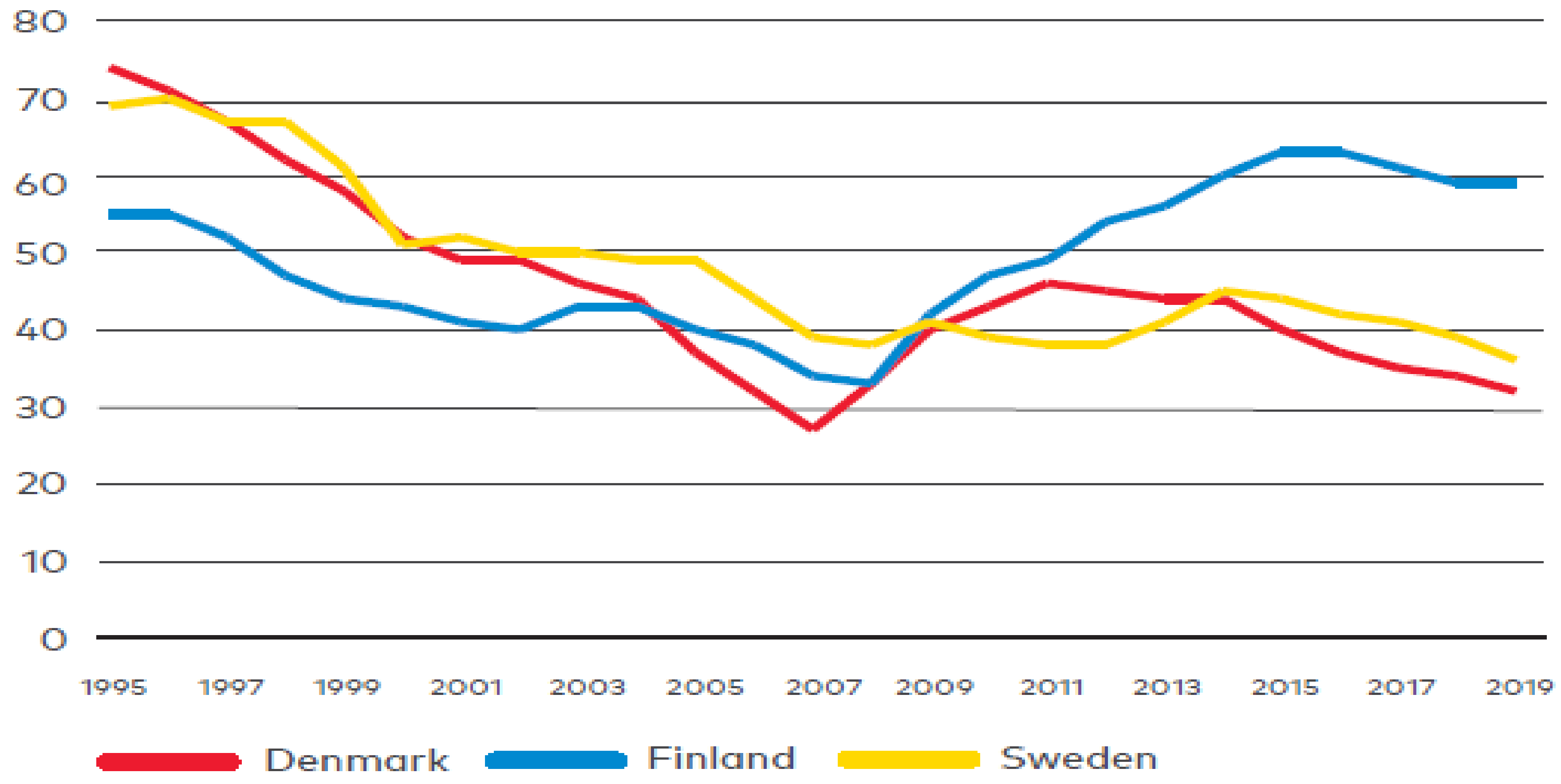


General government consolidated gross debt, percent of GDP



Fiscal rules

- Fiscal-balance targets/constraints
- Government debt targets
- Expenditure ceilings
- Economic results of local governments

	Fiscal-balance constraint general government	Fiscal-balance target general government	Subsector fiscal targets	Adjustment	Escape clause
Denmark	*Structural* deficit 0.5% of GDP	*Structural* balance 2025	Municipal sector, regional sector	0.5% of GDP annually	Exceptional circumstances
Finland	*Structural* deficit 0.5% of GDP	*Structural* balance 2023	Central government, municipal sector, social-security funds	0.5% of GDP annually	Exceptional circumstances
Iceland	*Actual* deficit 2.5% of GDP	*Actual* surplus over five-year period	Municipal sector		Deviation during 3 years is possible
Norway			*Structural* deficit for mainland Norway = expected return of wealth fund		Structural deficit can vary over the business cycle
Sweden		1/3% of GDP over business cycle: structural-balance target		0.4–0.5% of GDP annually	Adjustment should take cyclical situation into account

Debt rules

Iceland: Debt ceiling of 30% of GDP

Sweden: (Maastricht) debt anchor of 35% of GDP

Expenditure ceilings

	Sector	Scope	Time	Type	Compulsory action	Escape clause
Denmark	Central government: operating expediture and transfers Municipalities and regions: operating expenditure	Interest payments, investment expenditure and unem-ployment-related expenditure excluded	Four years ahead	Expenditure in real terms	Overdraft must be compensated unless taxes are raised; sanctions against municipalities and regions	Yes
Finland	Central government	Interest payments, financial investment and cyclically dependent expenditure excluded	Four years ahead	Expenditure in real terms	Not legally binding, but no violations	Yes
Sweden	Central government	Interest payments excluded	Three years ahead	Expenditure in nominal terms	Government must act against overdrafts	No

Budget rules for individual municipalities/regions

	Budget-balance requirements	Adjustment	Sanctions/actions
Denmark	Borrowing only for some investment expenditure		Reduction of government grants; government intervention
Finland	Ex-ante budget balance	Accumulated deficits to be covered within four years	Negotiations with government; forced mergers
Iceland	Ex-ante budget balance	Maximum debt: 150% of regular revenues	Government intervention; forced mergers
Norway	Ex-ante budget balance	Deficit to be covered within two years	Government intervention
Sweden	Ex-ante budget balance	Deficit to be covered within three years	**None**

Conclusions on fiscal frameworks

- Denmark has the strictest fiscal framework (in addition to EU rules)
  - law-based
  - tough expenditure ceilings
  - possibilities to sanction local governments
- Norway has the least strict framework (and no EU rules)
  - not law-based
  - no expenditure ceilings
- But rules have been complied with in both Denmark and Norway
  - **political consensus** more important than formal rules?

Fiscal councils

	Denmark	Finland	Iceland	Norway	Sweden
Fiscal Council	Economic Council(s)	Economic Policy Council	Fiscal Council		Fiscal Policy Council
Legal basis	Law regarding the council(s)	Government regulation	Budget law		Government regulation
Other monitoring institutions		National Audit Office			Konjunkturinsti-tutet, Ekonomi-styrningsverket, Riksrevisionen
Remit	Fiscal policy, other economic policy, environmental policy	Fiscal policy, other economic policy and economic-policy institutions	Fiscal policy		Fiscal policy, (growth, employ-ment and income distribution as well as policy transparency)
Own models and forecasts	Yes	Not yet	No		No

	Denmark	Finland	Iceland	Norway	Sweden
Link to budget process			Evaluation of main govern-ment policy documents in parliamentary budget process		Report after spring fiscal policy bill; public hearing in the finance committee
Media coverage	Large	Large	?		Large
Qualifications	Knowledge in economics; in practice university professors	Scientific expertise; in practice university professors	Knowledge on public finances; PhD for chair, university degree for others		Scientific competence in economics or practical economic-policy expirience
Appointment procedure	Proposal from council	Proposals from economics departments and Academy of Finland	Proposal from Prime Minister and parliament, respectively		Proposal from nomination committee: heads of govern-ment bodies and politicians
Secretariat	20-25 persons	2 persons	0 person		5 persons

Conclusions on Nordic fiscal councils

- Resources not commensurate with remits – Iceland, Finland and probably also Sweden
- No budget autonomy as recommended in OECD guidelines
- Strong **rea**l standing but weak **formal** guarantees for independence

  - potential risks
- No fiscal council in Norway

  - not in line with strong corporatist tradition – “Norwegian model”

Sustainable public finances

- ”The ability of a government to service its debt at any point of time”
- The *intertemporal budget constraint* must be fullfilled
  - current net financial wealth at least equal to present value of all future primary deficits (shares of GDP)
  - current net debt at most equal to present value of all future primary surpluses (shares of GDP)
- The path for the primary balance must be”economically and politically feasible”
- Difficult to judge
  - current government cannot make binding commitments on the part of future governments
- Basic assumption: interest rate > growth rate

Sustainability of current fiscal policy

Unchanged policy

- Constant tax rates
- Transfer levels to households rise in proportion to wages

  - but pensions follow the rules in the pension system
- *Collective* public consumption rises in proportion to GDP or population
- Expenditure per user on *individual* public consumption in various socioeconomic groups rises in proportion to wages

Other important assumptions

- Lower productivtiy growth in welfare services than in goods production
- Constant wage share in the private sector
- Same wage increase in private and in public sector
- Gradual normalisation of interest-growth differential
- Unchanged employment rate and average working time in various socioeconomic groups
- Some form of healthy ageing

Sustainability indicators

- S2 indicator

  - the immediate and permanent strengthening of the primary balance as a share of GDP which would *exactly* fulfill the intertemporal budget constraint – and stabilise net debt at some level

- S1 indicator

  - the immediate and permanent strengthening of the primary balance as a share of GDP which implies that a certain debt ratio (ratio of net financial wealth to GDP) is reached in a given year

- Developments of net financial wealth and debt as ratios of GDP

The S2 indicator

Advantages

- Information on fiscal sustainability condensed into one metric
- Allows comparisons between paths and countries

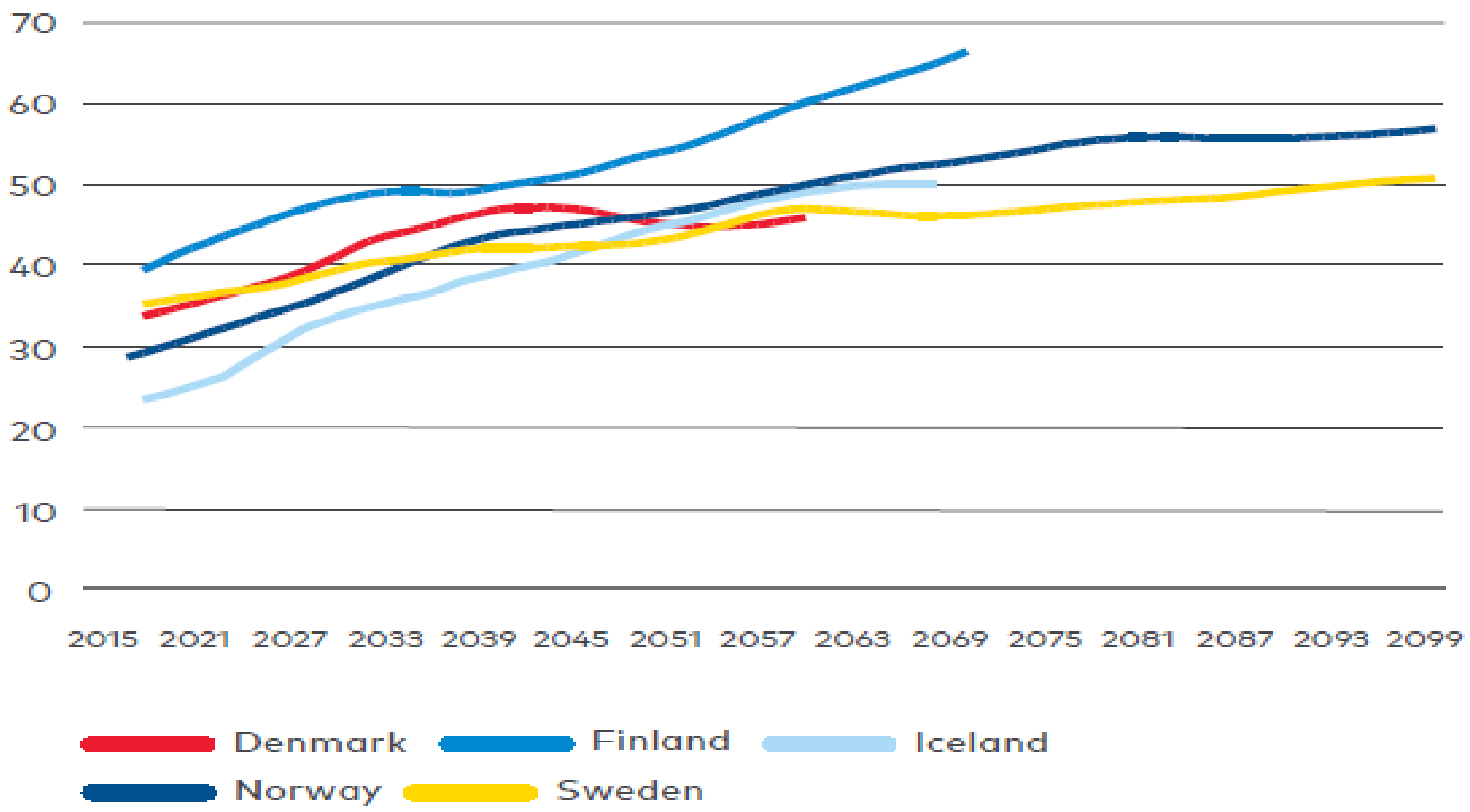
Disadvantages

- Too much information squeezed into one metric?
- The exact path matters
  - dangerous with large deficits in the near future even with large projected surpluses in a distant future
- S2 = 0 can imply very different long-run wealth and debt ratios

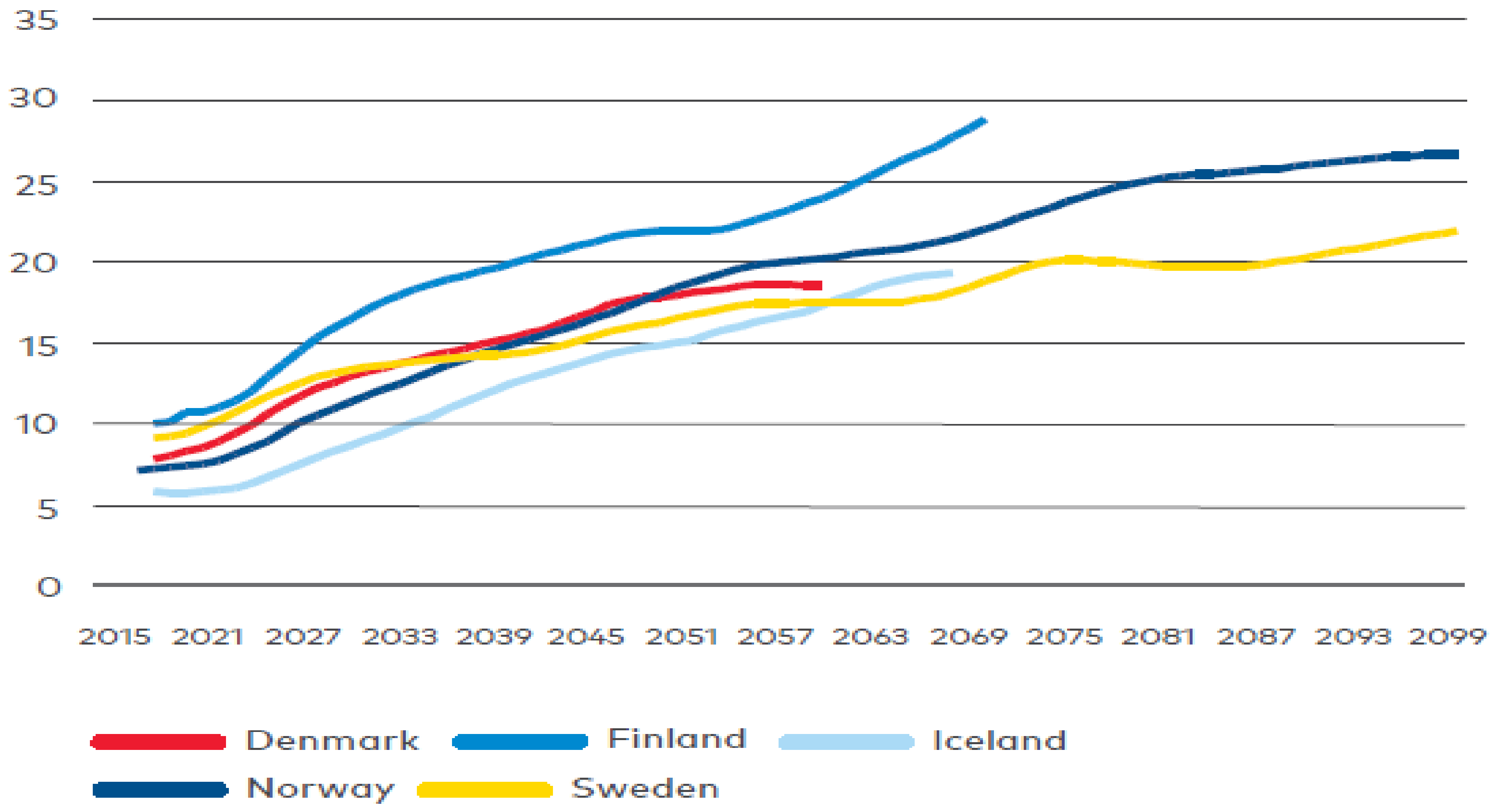
The S1 indicator

- Which debt ratio should be targeted?
  - 60% of GDP as in EU rules?
  - appropriate safety margin to 60%?
  - own debt target (35% of GDP as in Sweden)?
  - safety margin to *critical level?*
  - how determine critical level?
- Maastricht debt or net financial wealth?

Old-age dependency ratio (65+ as a share of 20– 64), percent



Oldest-age dependency ratio (80+ as share of 20-64), percent



Fiscal sustainability analyses

- **Denmark**
  - Ministry of Finance
  - The Economic Council(s)
  - (DREAM)
- **Finland**
  - Ministry of Finland
  - Bank of Finland
  - (ETLA)
  - (Economic Policy Council)
- **Norway**
  - Ministry of Finance
  - (Statistics Norway)
- **Sweden**
  - Ministry of Finance
  - National Institute of Economic Research
  - ((Fiscal Policy Council))

Observations regarding fiscal sustainability analyses 1

- Similar methods for projections of fiscal balance, net financial wealth and Maastricth debt
- In general highly competent analyses
- Large emphasis on S2 indicator in Denmark and Finland

  - operational role for policy

  - Denmark: S2 indicator should not be positive

  - Finland: Need for adjustment already in the short run if positive indicator
- Over time reduced emphasis on S2 indicator in Sweden

  - increasing emphasis on paths for fiscal balance, net financial wealth and debt

Observations regarding fiscal sustainability analyses 2

- Usually no S2 calculations in Norway
  - path for *fiscal gap* (”inndekningsbehovet”): every second year
  - required strengthening of central-government non-oil structural balance to reach overall central government budget balance (after withdrawal of 3% of wealth fund’s market value = expected real return)
- Surprisingly few S1 calculations
- Calculations mainly based on *extrapolation* method
  - dynamic OLG-models used by DREAM, ETLA (and National Institute of Economic Research)

Observations regarding fiscal sustainability analyses 3

- Extensive and pedagogical explanations in Denmark, Norway and Sweden
  - in particular the Economic Council(s) and the National Institute of Economic Research
- Insufficient pedagogics in Finland – Ministry of Finance
- Accounts of differences between various calculations
  - Sweden
  - Denmark: in particular the Economic Council(s) but not the Ministry of Finance
  - Finland: not at all

Observations regarding fiscal sustainability analyses 4

- The analysis of the Swedish Ministry of Finance stands out
  - assumption of unchanged standard in welfare services, unchanged exit age from labour market and no healthy ageing
  - expenditure per user in a given socioeconomic group falls relative to wages
  - deviation from historical patterns
  - net effect: too optimistic evaluation
- Norwegian Ministry of Finance
  - pedagogical calculations of how large adjustments are necessary if only one ”instrument” were to be used
  - tax on labour income, user charges, productivity growth in welfare service, higher employment

S2 indicator, percent of GDP

Denmark	-2 – -1
Finland	3 – 5
Sweden	-1 – 1
Norway	3 – 4
Norway fiscal gap 2060 (2100)	5,3 (9,5)

Reasons to be more pessimistic

- Relative wages in welfare sevices need to rise in order to recruit personell
- Increases in defence expenditure
- Corona crisis

Corona crisis: Sweden

- 6% GDP fall 2020
- Fiscal deficit: 5% of GDP
- Maastricht debt increase by 7–8% of GDP (to 42–43% of GDP)

- 10% GDP fall 2020
- Fiscal deficit: 7% of GDP
- Maastricht debt increase by 11–12% of GDP (to 46–47% of GDP)